Diversification and surprise: did you predict 9/11, 3/11 or the GFC?

The benefits of asset allocation and diversification are well-known. In Asia, education and the generational shift are driving Asian investors to embrace surprise and core strategic investment ideas, says Paul Stefansson of UBS Wealth Management.

The idea of investing in equities when stock markets are rising and then selling before prices fall has innate appeal. But having sufficient predictive power to time the market has been proven to be a thing of fantasy.

Instead, UBS Wealth Management's Paul Stefansson believes that market timing and asset allocation are mutually exclusive.

When one considers all the factors that affect markets, from terror attacks to whims of nature, it is easy to see why he thinks investors are better off if they build a diversified portfolio across sectors and geographies. After all, asset allocation controls risk.

"How many people predicted 9/11 (ie. terrorist attack), the Fukushima nuclear disaster (ie. earthquake) or the global financial crisis (ie. Lehman bankruptcy)?" asks Stefansson, head of IPS (investment products and services) portfolio specialists at UBS Wealth Management in Singapore.

There is clearly a case for a more rational approach to asset allocation. Plus, creating diversification in this way has obvious advantages: for example, it helps investors avoid too many nasty surprises; it protects their core holdings; and it can enable them to earn enough in returns to beat inflation.

"Clients understand the concept of surprise and why they need to build a portfolio that will protect them in all seasons, and also from the downside," explains Stefansson.

"That in essence is the difference between investment and speculation. When you hope for gigantic returns, you are not investing."

PAUL STEFANSSON
UBS Wealth Management

ENCOURAGING DIVERSIFICATION

Although the merits of this type of mind-set are well-known, getting Asian investors to see the virtue of allocating their money in different asset class continues to prove a challenge for advisers in the region.

Managing volatility

The flaws in making investment decisions which are driven by traditional biases have become more obvious in today's tough and uncertain market conditions.

"The problem with clients picking and choosing securities is that they don't always pick the right ones," says Stefansson. "They may become massively overweight on high-yield, for instance, which we have seen in this region for a long time."

He believes that the path to achieving high returns in volatile times is investing in a combination of equities, bonds, hedge funds, and private equity. He is especially bullish on private equity which forces investors to take a long-term view. Private equity forces investors to invest over a full 10-year bull and bear cycle. Many equity investors do not stay invested long enough to capture the long-term returns.

One of the main reasons for this reluctance to diversify is a lack of exposure among the local client base to modern portfolio theory. Compared with their peers in Europe and North America, Asian investors are more likely to go overweight on riskier assets like equities, currencies and commodities, despite this being a strategy that can easily backfire in times of turbulence. And such instances seem ever-likelier in a world of inter-dependent markets.

The fact that the majority of wealth in Asia has been created in the current generation by entrepreneurs, often helped by leverage, has made a more returns-focused approach to investing Asia inevitable, adds Stefansson.

What could spur change, he believes, is education and the generational change currently underway.

This is based on his experience of the second and third-generations of the region's wealthy, who have generally been educated in countries where diversification is commonplace. "The children of the first generation have been to universities like Harvard, Yale and Stanford," he says. "Generation Y understands modern portfolio theory and diversification."

FINDING THEIR FEET IN FUNDS

There has been some evidence of a change in investment patterns in Asia, however. More investors have started to build dependable investment portfolios by warming up to the idea of buying mutual funds.

"This gradual move from stocks and bonds to mutual funds or exchange-traded funds (ETFs) is a journey," says Stefansson. But it only represents the first step on the diversification ladder.

The other two elements – active advisory and then setting up discretionary portfolios – are still in their infancy in this region. Asia still very much trails Europe in terms of take-up of discretionary mandates; the single-digit percentage of AUM invested in this way is a far cry from the high double-digit percentage of investible assets in discretionary accounts in Europe.

Yet banks are trying to close the gap. "When you put our funds together, with our investment mandates and our active advisory, essentially with accounts where clients can get involved in their portfolio, we see some significant numbers," says Stefansson.

"Investors should look for a particular sector or market, and not a specific company, as there are downsides of doing that, especially in countries such as Canada."

PORTFOLIO BACKBONE

Regardless of the way investors achieve diversification, he cannot emphasise enough that this is the bedrock of any sensible strategy. It works two ways, too. "In volatile times, clients should look at building a portfolio that will not only protect them from the downside but also give them some upside."

At the same time, Stefansson's approach doesn't mean investors should see it as a free-for-all where they can simply select from bonds, hedge funds, ETFs and other assets. "Investors should look for a particular sector or market, and not a specific company, as there are downsides of doing that, especially in countries such as Canada which has significant exposure to resources." ■